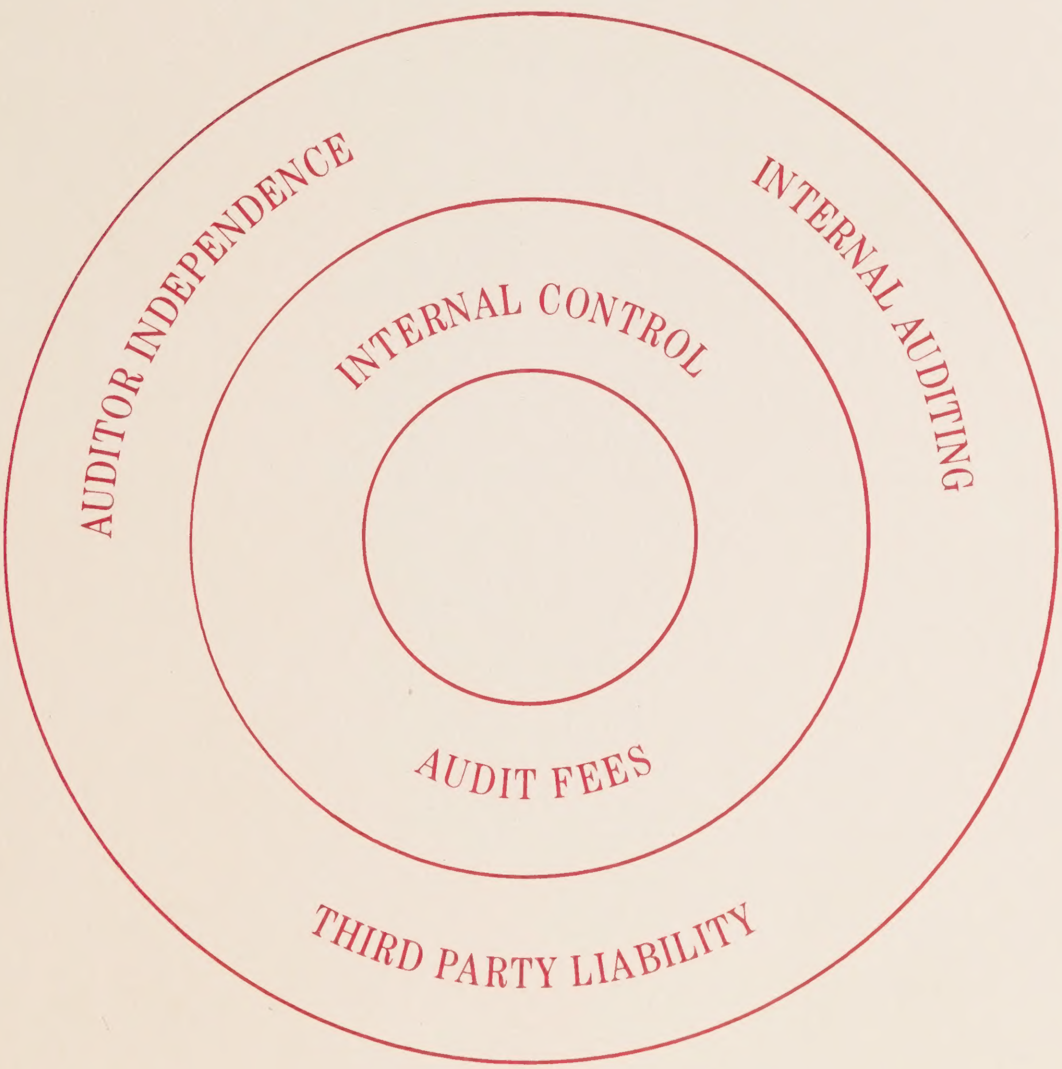
A
Management
Advisory
Publication

2 THE MUNICIPAL AUDIT
Other Responsibilities



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ISBN: 0-7729-3501-7

Price: $10.00

THE MUNICIPAL AUDIT
Other Responsibilities

Ministry of
Municipal
Affairs
Ontario John Eakins, Minister

June 1988

MUNICIPAL MANAGEMENT PRACTICES BRANCH

The Municipal Management Practices Branch of the Ministry of Municipal Affairs is committed to the promotion of management excellence in municipal operations.

This publication has been developed in consultation with municipal staff and municipal auditors. We are pleased to provide this material to you and hope it will be useful in the operation of your municipality.

Your comments on this publication are encouraged. If you would like to give us your thoughts, just fill in the form at the back of the publication. It will only take you a few minutes, and will help us to design our publications with your needs in mind.

Any questions regarding this publication should be addressed to the area field offices listed on the back cover. Comments on the publication's content should be addressed to Mare Brown at the address below.

Municipal Management Practices Branch
Ministry of Municipal Affairs
11th Floor, 777 Bay Street
Toronto, Ontario
M5G 2E5
(416) 585-7201

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A: Features for a Good Internal Control System

B: Continued Discussion of Third Party Liability

OVERVIEW

This is the second of two Management Advisory publications. As with the first publication, it is directed to all municipal officials, both elected and appointed, and is designed to inform and advise them about the purpose and nature of the municipal audit function.

The first publication, entitled "The Municipal Audit-Responsibility/Communication" was published in November 1986. As the title implies, it dealt with the responsibility and communication aspect between the auditor and the client.

The topics covered in the first publication were:

. What is an Auditor?
. Types of Audits
. Engagement Letters
. Reporting Requirement
. Client-Auditor Relationship
. Scope of Audit
. Materiality in Auditing
. Fraud
. Audit (or Equivalent) Committees
. Letters of Representation
. Management Letters

If you do not already have a copy of the first publication, it may be purchased, in person, from the Ontario Government Bookstore, 880 Bay Street, Toronto, M5S 1Z8 or, by mail order, from Publications Services Section, 5th Floor, 880 Bay Street, Toronto, M7A 1N8. (Telephone: 965-6015).

This publication covers the following topics:

Chapter 1--Internal Control

The purpose of this chapter is to describe the basic elements and management of internal control. A listing of features for good internal control procedures can be found in Appendix A.

Chapter 2--Internal Auditing

This chapter will discuss the need for internal auditing and the scope and objectives of the internal audit function. It will also cover the relationship with the external auditor, his or her status within the organization and the benefits of internal auditing.

Chapter 3--Auditor Independence

External auditors frequently provide bookkeeping/accounting services either directly or through related service bureaus or bookkeeping organizations. Municipalities also rely to a large extent on their auditor to prepare the financial statements and sometimes to provide management consulting services. This chapter will discuss the need for auditor independence and provide guidelines to municipal auditors and municipalities to reflect those services where a potential conflict of interest and loss of independence could arise.

Chapter 4--Audit Fees

This chapter will discuss the criteria for assessing the value of the audit conducted and the factors that can help to minimize audit fees. Methods of evaluating the appropriateness of audit fees and how to resolve audit fees disputes will also be discussed.

Chapter 5--Third Party Liability

Third party liability is an area in which public accountants are particularly vulnerable. A general discussion on the liability of a public accountant for a loss suffered by a person other than his or her own client is outlined in Appendix B.

CHAPTER 1 INTERNAL CONTROL

Internal control can do much to protect against fraud and assure the reliability of accounting data. But it is important to recognize the limitations in any system of internal control. Errors may be made in the performance of control procedures as a result of carelessness, misunderstanding of instructions, or other human factors. Those control procedures which depend on separation of duties may be circumvented by collusion among employees. Since most controls are directed at regularly recurring types of transactions, their efficiency may vary with the volume of transactions or changes of staff.

Considerations of cost will limit how much internal control is adopted by a municipality. A system of internal control so perfect as to make any fraud or error impossible would cost more to maintain than warranted by the expected benefits. Particularly in a small municipality with only a few employees, it is often impracticable to separate completely the custody of assets from the function of recordkeeping. Despite these limitations, however, many actual defalcations or frauds would have been prevented or disclosed at an early stage if even the most simple and inexpensive of internal control practices had been followed.

Definition

The Canadian Institute of Chartered Accountants Handbook defines internal control as comprising "the plan of organization and all the co-ordinate systems established by the management of an enterprise to assist in achieving management's objective of ensuring, as far as is practical, the orderly and efficient conduct of its business, including the safeguarding of assets, the reliability of accounting records, and the timely preparation of reliable financial information."

Internal control procedures and measures can be subdivided into two general categories:

<u>Administrative Controls</u>
These controls are concerned mainly with operational efficiency and adherence to prescribed managerial policies. They have only an indirect relationship to the accounting and financial records.

<u>Accounting Controls</u>
These controls are concerned mainly with safeguarding of assets, the recording of liabilities and the reliability of financial records. They have a direct relationship to the accounting and financial records.

Objectives

The system of internal control constitutes all the measures, procedures and activities that serve to check or promote the proper recording of transactions in the records and books-of-account of the municipality, the safeguarding of assets, the improvement of operational efficiency and effectiveness, and the adherence to prescribed policies and statutory requirements. Secondary objectives of internal control would involve procedures designed to:

i) ensure timely preparation of financial information for decision-making and monitoring purposes;

ii) avoid unintentional exposure to risk;

iii) prevent or detect errors and irregularities; and

iv) ensure that delegated responsibilities are properly discharged.

The extent and detail of controls designed and implemented to accomplish these broad objectives must be based on the degree of risk to assets - whether that risk is loss, error or misuse. Obviously, the greater the risk, the greater the degree of required controls.

Phases of Internal Control

The installation of a system of internal control consists of three stages or phases:

(i) design of the system;

(ii) implementation of specific features or procedures; and

(iii) evaluation of the effectiveness of the system implemented to ascertain whether the controls are operating as intended.

Furthermore, internal control should be considered from the perspective of the responsibilities of members of council, officers of the municipality and the independent external auditor.

The establishment and maintenance of an internal control system is a managerial responsibility. The treasurer of the municipality should be responsible for the design and implementation of the accounting system and hence the internal control system which is a component of the accounting system. Members of council should, in essence, oversee or monitor the performance of the municipality by way of receiving regular reports and financial statements.

Features of Internal Control

Internal control features are those procedures instituted into the accounting system or process to prevent or detect:

(i) errors that are unintentional; and/or

(ii) irregularities that are intentional.

An unintentional error is a mistake. It arises from carelessness or a lack of adequate knowledge.

An intentional error arises from deliberate planning, usually involving a dishonest person. Such an act may become the basis of legal action.

Appendix A lists the procedures that are the essential characteristics of a good internal control system. However, this list is not all-inclusive. An elementary procedure such as requiring all records to be kept in ink rather than pencil can be considered a form of internal control. It should be noted also in this context that the adequacy of internal control is subjective and subject to change or re-evaluation due to changed circumstances or procedures. The system of internal control should be considered in degrees of adequacy or inadequacy.

No system of internal control can be foolproof or perfect. Any system can be circumvented by:

i) carelessness or incompetence on the part of personnel whose duties and responsibilities are considered an integral part of the internal control;

ii) deliberate alteration or manipulation of the

accounting records to conceal a shortage or other irregularity; and

iii) lack of adequate preventive or detective controls such as poor segregation of duties and responsibilities that are incompatible.

An adequate internal control system would **probably** prevent these occurrences or would **at least** detect them after the fact. It should be emphasized, however, that in considering the internal controls to be instituted, the cost of the control should not be greater than the potential benefit it is expected to achieve. It is possible to have too many controls, which result in increased staff time in performing the control function and investigating errors and/or delays which result in inefficient operations.

Internal Control for a Small Municipality

Because internal control is often mistakenly believed as demanding an elaborate division of duties, it may be thought that a sound system of internal control is not feasible for a small municipality. This view does not take into consideration the many internal control features which operate independently and automatically, or the contribution toward an effective system which the treasurer himself can make.

It would be unreasonable to expect a small municipality to have an internal auditor. However, if the basic features of internal control are examined, it becomes apparent that most are applicable to both large and small municipalities. Even though it may not be common to formalize policies in manuals, it is certainly possible for a small municipality to have competent, trustworthy personnel with clear lines of authority; proper procedures for authorization, execution and recording of transactions; adequate documents, records and reports; physical

control over assets and records; and, to a limited degree, checks on performance.

In municipalities having only one or two office staff, it will obviously not be possible or efficient to segregate accounting duties. In such instances, council or a committee of council should become more involved in overseeing, reviewing and approving the operations of the treasury department on a day to day basis. Such involvement could take the form of periodically reviewing and approving a listing of cheque payments, having a member of council sign cheques, approve payrolls, purchases, payments and review financial statements.

One major control available in a small municipality is the knowledge and concern of the treasurer. A personal interest in the municipality and a close relationship with the personnel make possible careful evaluation of the competence of the employees and the effectiveness of the overall system. For example, the system can be significantly strengthened if the treasurer conscientiously performs such duties as carefully reviewing supporting documents before signing cheques, reviewing bank reconciliations, examining tax arrears notices, examining all correspondence from ratepayers and suppliers.

Instances where discrepancies or errors are uncovered should be investigated thoroughly and resolved to the satisfaction of council or a committee of council. In addition, in instances such as these, council should formally require its municipal auditor to perform additional detailed checking of the transactions recorded in the accounts and to provide a management letter indicating areas of significant weaknesses and recommendations as to how the weakness could be reduced or minimized.

Role of the External Auditor

In order for the external auditor to express an opinion on the financial statements, he must review and evaluate the adequacy and effectiveness of the internal control system. Careless financial control, careless management and careless accounting make an audit difficult and costly and limit its reliability resulting in a qualified opinion. The external auditor would be concerned mainly with ensuring that adequate preventive and detective controls exist so as to ensure:

(i) that the assets and liabilities of the municipality are properly accounted for at all times (i.e. assets are safeguarded against loss, destruction or unauthorized use); and

(ii) that the accounting system is compiling financial information on a timely, valid, complete, accurate and reliable basis for use in the stewardship and decision-making process.

It should be noted that the external auditor's responsibility extends beyond just reviewing and evaluating internal control to:

(i) providing a management letter or letter on internal control weaknesses to the treasurer and/or council. Such a letter could be made mandatory through the engagement letter and is usually prepared by the external auditor as a by-product of his attest audit engagement to document his findings and recommendations; and

(ii) considering any serious deficiencies in the internal control system that may have a material impact on the fairness of presentation of financial data in the

financial statements. An external auditor in performing an attest audit (i.e., a statutory audit requiring an attestation or opinion on the financial statements) has to rely on the integrity and reliability of the accounting records in that it is not possible or economically justifiable for him to audit all records and documents. An adequate system of internal control enables an auditor to limit his audit testing without impairing the quality or coverage of his examination.

The external auditor, on the basis of his evaluation of the system of internal control may provide assistance and advice on these matters. Municipal officials should confer with the external auditor on an on-going basis as to :

(i) what areas of internal control are weak or deficient and require improvement;

(ii) what feasible internal control features or procedures could be implemented to reduce or eliminate the weakness, given the constraints or circumstances existing in the municipality's operations;

(iii) how any changes in internal control procedures would be implemented, taking into consideration the limited staff size and the need to ensure proper division of duties; and

(iv) the manner in which the proposed changes would be monitored and evaluated for any unforeseen problems or weaknesses.

Council and municipal officials should make it a practice to consult the external auditor whenever they encounter any problems

or changes in circumstances that relate directly to the accounting and control systems. However, this would occur only if they cannot resolve the problems by themselves, otherwise, the auditor's charges would get costly. Changes in staff, rotation of duties, additional accounting procedures or reporting requirements, elimination or curtailment of certain accounting practices and/or any changes in the frequency of performing certain functions should be discussed with the auditor beforehand.

Ideally, council or delegated municipal officials should co-ordinate all their activities pertaining to the design of, and changes in, the internal control system with the external auditor. This could be done each year when the auditor has completed his interim audit and submitted his management letter.

Internal Auditing - Its Relationship to Internal Control

Another basic component of a strong internal control is an internal auditing staff. Internal auditors investigate and appraise the system of internal control and the efficiency with which the various departments of the municipality are performing their assigned functions; they report their findings and make recommendations to top management. Please refer to chapter 2 on Internal Auditing.

Summary

To put this chapter into perspective, the following should be emphasized:

<u>Management Responsibility</u>
Management, not the auditor, must set up and monitor the municipality's internal control system. This concept is

consistent with the requirement that management is responsible for the preparation of financial statements in accordance with generally accepted accounting principles.

The basic objective of orderly management is the plan of organization. This is vital and cannot be overemphasized. A system alone is not enough as it is influenced by the relation of costs and benefits and the unpredictability of human behaviour. The plan of organization as defined on page 1 of this chapter needs constant review to adjust for changed circumstances and to guard against the cumulative effect of small changes made with inadequate consideration.

<u>Reasonable Assurance</u>

A municipality should develop an internal control system that provides reasonable assurance that the financial statements are fairly stated. Internal control systems are developed by management after considering both the costs and benefits of the controls. Management is often unwilling to implement an ideal system because the costs may be too high. For example, it is unreasonable for auditors to expect management of a small municipality to hire several additional accounting personnel to bring about a small improvement in the reliability of accounting data. It is often less expensive to have auditors do more extensive auditing than to incur higher internal control costs. If auditors find material errors, the scope of the audit can be adjusted to compensate, and recommendations made for improvements in the system.

<u>Fidelity Bonds</u>

A strong internal control is not a guarantee against losses from dishonest employees. Neither is it possible to prevent fraud by emphasizing the selection of trustworthy employees. Some of the biggest embezzlements have been carried out by the most trusted employees. The fact that they are so highly trusted explains why

they have access to cash, securities and records and are in a position that makes embezzlement possible.

Fidelity bonds are a form of insurance in which a bonding company agrees to reimburse the employer, within limits, for losses attributable to theft or embezzlement by bonded employees. Most employers require employees handling cash or other negotiable assets to be bonded.

Fidelity bonds should not be considered a substitute for internal control. If internal control is weak, losses may accumulate undiscovered until they exceed the fidelity coverage. Theft or defalcation must be discovered and the loss proved before recovery can be obtained from a bonding company.

CHAPTER 2 INTERNAL AUDITING

Internal auditing is defined in "The Practice of Modern Internal Auditing" by L. B. Sawyer as:

> An independent appraisal of the diverse operations and controls within an organization to determine whether acceptable policies and procedures are followed, established standards are met, resources are used efficiently and economically, and the organization's objectives are being achieved.

The term "internal" emphasizes that the audit is conducted by employees within the municipality. This distinguishes it from auditing conducted by outside public accountants or external auditors or any other parties not directly a part of the particular municipality.

Need for Internal Auditing

There is a need to know whether municipal funds are handled properly and in compliance with existing laws and regulations. In addition, it should be determined whether these municipal services are being provided efficiently and economically. This information, therefore, should be provided by someone who is independent and not part of the program development and delivery system.

Because internal auditors are experts on control, their insight, directed at management (including council), can assist in accomplishing stated objectives by recommending change.

The internal auditing department is an integral part of the municipality and functions under the policies established by

management. The statement of purpose, authority and responsibility for the internal auditing department, approved by department heads and accepted by council, should be consistent with those Standards for the Professional Practice of Internal Auditing established by the Institute of Internal Auditors.

Objective

The objective is to assist all members of management in the effective discharge of their responsibilities and consists of four aspects:

- assurance;
- discussion of the facts;
- timely reporting; and
- change.

Assurance

Assurance means that control processes are satisfactory or that improvements are necessary; findings should be supported by a description of the work carried out in arriving at conclusions and should include an assessment of the risks involved where weaknesses are found.

Discussion of the Facts

There should be discussion and agreement with management on the facts leading to the conclusion or opinion. This should result in some reasonable course of action to cure any weaknesses.

Timely Reporting

There should be timely reporting of information to management concerning potential control problems or issues. Examples might include: recommendations made and not implemented; policies or directives which are no longer viable; comments of department heads concerning actions taken or their view of the weakness;

the reliability of information provided through management's reporting process and new systems and information relating to safety or security.

<u>Change</u>
The internal auditor can recommend changes to correct any weaknesses. The auditor's relationships with those being audited, the way in which his report is expressed and his credibility and reputation increase the likelihood that the audit process will lead to constructive change.

Scope

The scope of internal auditing includes:

- reviewing the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information;

- reviewing the systems established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant impact on operations and reports, and determining whether the municipality is in compliance;

- reviewing the means of safeguarding assets and, as appropriate, verifying the existence of such assets;

- appraising the economy and efficiency with which resources are employed; and

- reviewing operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.

Internal versus External Auditing

The internal auditor and the external auditor share many common interests, and many of the techniques they employ are essentially the same. A better understanding of their relationship to the municipality can be obtained by comparing the differences in objectives, responsibilities, scope of activities and procedures between these two professional groups.

Internal Auditing	External Auditing
The principal objective of the internal auditor is to aid management in achieving efficiency, effectiveness and economy.	The principal objective of the external auditor is to report to the council, inhabitants and ratepayers on the overall fairness of the municipality's financial statements.
As an employee of the municipality, the internal auditor can never be completely independent of management, but his value to management lies in his independent position within the municipality, which allows him to have an objective outlook.	The external auditor is not an employee and is completely independent of the management in that he reports to the council, inhabitants and ratepayers.

Internal Auditing

The scope of the internal auditor's activity is determined by council as well as by the department heads. The review and appraisal of the internal control system is normally the primary concern. The deterrence of fraud remains the responsibility of management. Internal auditors are responsible for examining and evaluating the adequacy and effectiveness of actions taken by management to fulfill this obligation.

The internal auditor exercises a reasonable amount of freedom in methods and procedures suitable to accomplish his goals. In the area of financial auditing, the internal auditor adopts generally accepted auditing standards. He may make these decisions in concert with management. The internal auditor's review of the municipality's activities is continuous.

External Auditing

The external auditor examines only those activities necessary to allow him to form an opinion of the municipality's financial position. The external auditor may test and review internal controls to determine the extent to which he can rely on them. He is only incidentally concerned with the detection of fraud unless such fraud directly involves the fairness of the financial statements.

The external auditor must follow generally accepted auditing standards in order to report that the municipality's financial statements are prepared in accordance with generally accepted accounting principles. The external auditor's examination is periodic.

Relationship with External Auditor

Cooperation and coordination between the external and the internal auditor are essential in order to avoid duplication and reduce the overall costs of both types of audits. For the external and internal auditor to complement one another in their work there must first be a free exchange of ideas. This is something that will not occur until there is a mutual respect of each group's objectives and responsibilities and a thorough understanding of each group's audit coverage.

A fully functioning internal auditing department can ease the work of the external auditor by recommending improvements in internal controls throughout the municipality. The internal auditor can be an important source of information and education by providing an orientation program for the external auditor. Also, the internal auditor will obviously be the person who provides the auditor with his working papers. At the same time the external auditor can provide the internal auditor with a fresh point of view as to how the work could be done more effectively, gained from his experience in auditing other municipalities.

The internal and external auditors should determine between themselves in what areas it would be advisable and practical to carry out joint audits and what areas must be subject to the independent analysis. The final decision as to the scope of the external auditor's work will be determined by the external auditor alone because of his professional responsibility to preserve the independence of his work. However, there may be areas where a slight modification of internal auditing procedures would make the internal auditing results usable by the external auditor, thus eliminating or considerably reducing the work of the external auditor in those areas.

Section 5215.18 of The Canadian Institute of Chartered Accountants Handbook states that the external auditor may rely on the internal auditor's review and testing of the internal control system. Where the internal auditor performs a control procedure, it would be considered as any other control. The external auditor is responsible for verification, which includes reviewing and testing the work performed by the internal auditing department, since that is part of the municipality's internal control.

The cooperation between these two groups can be mutually beneficial provided the internal auditing function is not mistakenly viewed as an extension of external auditing and the internal auditor not seen as an employee of the external auditor.

Independence

A key characteristic of an effective internal audit department is the degree of independence with which it operates. Internal auditors should be free of organizational pressures that limit their objectivity in selecting areas to be examined or in evaluating and reporting upon those areas. Internal audit independence is strengthened when the auditors are afforded free access to and direct channels for reporting findings to council, department heads and the audit committee or its equivalent.

A basic principle of good organization is that no one can be expected to evaluate his own work objectively and no one should be expected to evaluate the work of the executive to whom he reports. Theoretically, an internal auditor cannot be truly independent when he reports to the treasurer or the director of finance. The dual responsibilities for the operation of an important portion of the internal accounting control system and for its surveillance by the internal auditors are therefore inherently incompatible. The internal auditor's responsibility

for internal control should be to review and advise rather than to implement and maintain.

Determination of the specific executive to whom the internal audit department reports depends upon various circumstances. The size of the municipality, the organizational structure, the number of reporting possibilities and the specific responsibilities assigned to each individual executive all play a part. The level of work assigned to the department is also a consideration.

Plans for providing the internal audit department with a channel of communication to the audit committee deserves consideration in determining the reporting level of the department in the municipality. Too low a placement may present an awkward situation if the head of internal audit needs to bypass a long line of superiors to meet the audit committee.

In view of the need for independence, it is frequently argued that the head of internal audit should report directly to council or to the audit committee. Failing that, the internal auditor should report to the chief administrative officer who has substantial authority in a non-financial area and should have direct access to council regarding matters that he or she considers vital. Even when reporting to the chief administrative officer is not feasible, the internal auditor must have sufficient status to deal with operating managers on an equal, not a subordinate, level. Of the municipalities in Ontario with internal auditors, approximately two-thirds report to a chief administrative officer.

Objectivity

The Institute of Internal Auditors Standards for the Professional Practice of Internal Auditing defines objectivity as an

independent mental attitude which internal auditors should maintain in performing audits. Internal auditors are not to subordinate their judgment on audit matters to that of others.

Role of Internal Auditor

When a municipality is small, its treasurer is intimately acquainted with all phases of its operation. However, as the municipality grows and its operations grow in complexity, the treasurer and other department heads may be unable to maintain control. Where this occurs, the internal auditor will cross all boundaries to assist management.

Traditionally, internal auditing was limited to the detection of errors and irregularities in financial transactions. The internal auditing department was considered a psychological deterrent to wrongdoing, and its success was often measured by the number of errors and defalcations uncovered.

The internal auditor or his staff spent hours labouriously verifying cash on hand, bank deposits, accounts receivable, inventories and other assets. He looked strictly for things that were wrong, for deviation from corporate policies and procedures, and for accuracy of accounting records prepared by bookkeepers and others charged with recording transactions. Although the internal auditor became thoroughly familiar with many operations and could have made valuable suggestions for their improvements, he confined his report to revealing disparities in actions already taken and mistakes already made.

As organizations change, so has internal auditing. Computers now do most of the bookkeeper's work and the figures that were labouriously ticked off are processed inside the computer. Internal auditing is now a managerial approach to reviewing operations and controls that requires a different state of mind

and a higher order of skills and training on the part of the internal auditor. Instead of a negative, protective or clerical function, modern internal auditing is now a positive, constructive and creative service to management. For example, in the examination of accounts receivable, the internal auditor would in the past have been concerned solely with determining whether the receivables were properly recorded. In contrast, today's internal auditor raises a host of questions of managerial concern about the overall operation of the accounting department and thus expands the financial audit into a much broader operational audit.

Internal Auditing Activities

Many managers have realized that a tight control system in the accounting and financial areas alone is not enough; there is a need to know more about operational controls which are made increasingly complex by organizational growth and computer technology. Today, internal auditing activities may extend into such areas as delivery of service, personnel, purchasing, engineering, compliance with laws and regulations, and conflicts of interest of staff and members of council.

Internal auditing activities fall into two major catagories, financial auditing and operational auditing:

Financial Auditing attempts to verify the existence of assets and liabilities and to ascertain that proper safeguards against loss, theft or misuse are maintained.

Operational Auditing involves the extension of internal auditing to all operations of a municipality and does not confine itself to the financial and accounting areas.

Under operational auditing, two areas of potential conflict can be avoided if it is remembered that internal auditing is distinct from both program evaluation and the responsibilities associated with management. Program evaluation is a different and separate function which considers the effectiveness of the existing program to determine, in the light of present circumstances, its adequacy, relevance and the alternatives available. In other words, a program evaluator basically questions if a program is still needed. An internal auditor, on the other hand, accepts the validity of the program and reports to the manager on whether or not the manager has adequate control over it.

It is management's responsibility to operate programs efficiently and economically. Hence, management develops, implements and maintains the necessary control systems, such as systems for measuring productivity or for reporting progress against plans. Auditors aid managers by evaluating control systems and reporting on whether they work well.

Internal auditing is not meant to second-guess management nor is it a "witch-hunt" to find errors. Rather, it is meant to be a positive tool which managers can use to help ensure the success of their programs.

Audit Procedures

The auditing of any operation involves a number of distinct responsibilities. These normally include familiarization, verification, evaluation, compliance, recommendations and follow-up. By carrying out these responsibilities the internal auditor makes certain that management receives a flow of unbiased information indicating the effectiveness of its policies and operations.

Familiarization

The auditor needs to become familiar with the operation's basic objectives, organizational structure, policies and procedures, functions, identification of key controls, responsibilities and other significant activities through a pre-audit review. The standards of performance used by management are important to measure the success or failure of a unit in achieving its goals. The auditor can gain insight into the potential problems through observation and questioning, accompanied by a review of prior years' financial records, operating reports generated by the departments and a review of job descriptions.

Verification

Verification is attesting to the truth, accuracy and reliability of reported data. When protection is the primary focus, the auditor examines the accounting records and reports, particularly the firm's assets and liabilities. Verification of assets may include the examination of cash, receivables, securities and disbursements. Contracts, agreements and leases may be reviewed to assure appropriateness of service rendered. Verification activities may also include reports on accounts aging, employee absences, overtime and accident reports.

In the financial area, the internal verification activities may be closely related to external auditing, which frequently lessens the work required of the independent auditor. Furthermore, management frequently needs such information on a continual basis, something the outside auditor is not in a position to provide.

Evaluation

One of the auditor's most important responsibilities is the evaluation function. This necessitates a very high degree of professional judgment. There can be no definite boundary between this function and verification, and often the two functions are

conducted simultaneously. Without evaluation, verification is merely a clerical activity.

Internal auditors must evaluate the control systems to determine if they are adequate and operating as management expects. They must also ask if such procedures are still relevant and applicable. Are safeguards and security procedures sufficient?

In addition to evaluating controls, the internal auditors may be involved in evaluating departmental performance. The internal auditors should refrain from reporting on the performance of individual employees unless asked to do so by council. They should concentrate on evaluating a particular part of the municipality's success in achieving its objectives by measuring results against performance standards. Evaluation of a situation elicits less resistance than evaluation of an individual, and usually the latter is done only when wrongdoing is suspected.

Compliance

Compliance refers to the extent to which policies, plans, rules and procedures are followed in actual practice. Often municipal policies, procedures, legislation and regulations are not known or understood at all management levels. It then becomes the internal auditor's responsibility to ensure that these policies and procedures have been properly communicated as well as observed or reviewed for change.

Recommendations

The internal auditor should not only point out problems but also recommend appropriate solutions and commend management on well-run operations. Since the internal auditor delves deeply into all areas of operations, he or she can be a continual source of suggestions for improvements in efficiency and cost reduction.

The fullest potential of internal auditing as a service to management lies in this ability to make recommendations based on evaluation of operational or financial data. The internal auditor should work with management to get agreement on the facts and a commitment to correct the deficiency. The auditor must strive to make recommendations that are practical, objective, reliable and timely. To sum up, the internal auditor must recommend or advise on improvements, not develop them, install them or direct them.

Follow-up

Since internal auditing is a staff function, the primary responsibility for instigating action and following up on internal auditing recommendations lies with management. Where management accepts this primary responsibility and provides prompt and effective follow-up, operating units realize that management strongly supports internal auditing. When management follow-up is not prompt and firm, operating units become far more lax about correcting deficiencies.

The follow-up does not mean strict compliance with all audit recommendations. The operating managers may disagree with the recommendations or may in fact find a better solution for a particular problem. These differences must be reconciled, but the internal auditor must follow-up to find out whether his recommendations have received management's consideration and to make certain that management takes formalized action on them within a reasonable length of time.

Benefits

An effective internal audit program provides a number of benefits to the municipality. The most important, of course, is timely advice to the management when weaknesses are found in any of the control processes. This advice enables them to take corrective action quickly.

Because a municipality is so close to its taxpayers (compared to provincial and federal governments) one of the important benefits of internal auditing is that it can lead to increased productivity and lower costs. It can also provide management with feedback on the functioning of their financial and management policies. The audit can identify opportunities for improving such policies and can promote understanding of them by those being audited.

Perhaps the greatest advantage of the expanded auditing role will be felt by large municipalities where authority is delegated. In these situations sound accountability and control systems are critical. Therefore, assurances from the audit group on the state of these systems is particularly essential.

CHAPTER 3 AUDITOR INDEPENDENCE

In Ontario, municipal auditors frequently provide services, other than auditing, to their municipal clients. These services include:

- the preparation of the annual financial statements;
- advice and assistance in the design and installation of bookkeeping and internal control systems;
- bookkeeping services either directly or indirectly through a related service bureau or bookkeeping organization;
- the interviewing of professional staff;
- advice and assistance in evaluating and installing computer systems; and
- general consulting services either directly or indirectly through a separate entity.

This is similar to the practice in the private sector. There has been, and still are, those who question the auditors' independence when performing these additional services for their clients. The purpose of this chapter is not to identify acceptable and unacceptable services provided by the auditing firm, since each individual case must be examined separately. The following is a discussion to make the reader aware of the factors which should be considered.

What is Auditor Independence ?

The very purpose and nature of an audit is to obtain the independent opinion of the auditor. Independence can be defined as the state of not being influenced or controlled by others in matters of opinion or conduct; thinking or acting for oneself; not subject to another's authority or jurisdiction; autonomous; free.

The auditors' independent opinion that the financial statements of the municipality present fairly the financial position and operations of the municipality gives the users increased confidence in those financial statements. It is the independence of the review and report on management's (including council's) representations on their financial statements as to their performance and stewardship that gives rise to the increased confidence.

Legislative Requirements

Section 88(6) of the Municipal Act states that no person shall be appointed as an auditor of a municipality who is or was a member of council or any local board of that municipality in the current or the preceding year.

This section of the Act also disqualifies a person as an auditor of a municipality who has or had in the preceding year "any direct or indirect interest in any contract or any employment with the municipality or any of such local boards other than for services within his professional capacity." There is no definition of "within his professional capacity" provided by the Ministry, nor has any court action occurred which would provide a definition.

Rules of Professional Conduct - The Institute of Chartered Accountants of Ontario

The Institute of Chartered Accountants of Ontario "Rules of Professional Conduct" state that the auditor "shall hold himself free of influence, interest, or relationship which impairs his professional judgment or objectivity" or appears to do so to the reasonable observer. This statement reflects the two facets of independence: independence in fact, and independence in appearance.

CICA Handbook Section 5100.02 - Generally Accepted Auditing Standards

The examination should be performed and the report prepared by a person or persons having adequate technical training and proficiency in auditing, with due care and an objective state of mind.

Importance of Auditor Independence

It is evident that there is an "expectation gap" between auditors and the public. In other words, there is a difference between the assurances the public **thinks** are provided by an auditor's opinion on the financial statements and what is **actually** provided. There also appears to be a difference in what auditors currently provide and what those relying on audit reports want or believe they are getting. The expectation gap thus has implications for the perception of independence as well as the actual fact of remaining independent.

As a direct result of the failures of the Canadian Commercial Bank and the Northland Bank, The Canadian Institute of Chartered Accountants has set up a Commission to Study the Expectations of Audits, chaired by William Macdonald.

Auditors need to increase public awareness of what are responsibilities and obligations, and, just as important, the limitations of an audit.

The argument has been made that where the auditor provides services such as preparation of the financial statements to be audited, design and installation of bookkeeping and internal control systems, and general consulting, the auditor is no longer independent. Without this perceived independence, the auditor cannot render a valid audit opinion because there is a conflict

of interest. In reality, however, the independent auditor is selected and paid by someone affected by the audit. Consequently, total independence is a practical impossibility. As well, as an auditor establishes a relationship with a client, a certain degree of independence is lost due to the personal contact between the two parties. While this slight infringement on independence would not prevent the auditor from acting in an objective manner, it must be recognized that additional contacts on a social or civic basis would not enhance the perception of the auditors' independence. Therefore, the practitioner must carefully evaluate his relationship with a client and avoid, or at least minimize, those circumstances that contribute to the perceived loss of independence.

If total independence is a practical impossibility, how can the degree of independence, vital to the audit function, be strengthened to provide an acceptable level of assurance of independence?

Suggestions have been made that there could be a segregation of audit functions from management consulting functions. That is, an auditor might be prohibited from providing both audit and management consulting services to the same client. Other suggestions include limiting the value of other services to 50 per cent of the audit fee and/or making it mandatory to disclose audit and consulting fees when preparing financial statements.

Proposals for Strengthening Auditor Independence

The Cohen Commission in their study entitled "The Commission on Auditors' Responsibilities" considered the following three proposals in relation to auditor independence:

- restricting services provided by public accounting firms that might be incompatible with the audit function;

- protecting the auditor from management influence; and

- assuring that public accounting firms are managed in a manner that provides the necessary internal support for the independence of individual partners and staff.

The Commission's findings with regard to these three proposals are as follows:

- "There is no evidence that provision of services other than auditing has actually impaired the independence of auditors. However, the belief of a significant minority of users that independence is impaired creates a major problem for the accounting profession. Decisions on the other services offered and used should be made by individual public accounting firms and the Council and/or audit committee."

- "The present relationship between management and the auditor needs to be modified substantially to provide more support for the auditors' independence."

- "Management policies of accounting firms - particularly those related to pricing and the related pressures on staff to reduce time and costs - have a negative effect on the ability of auditors to remain independent and should be improved."

- "Elements in the business environment such as arbitrary time deadlines affect the quality of the audit, place unnecessary stress on the auditors' independence, and should be changed."

Guidelines for Evaluating Additional Services

Because the perception of independence is so subjective, there can be no hard and fast rules for which particular services might result in a loss of independence. The Cohen Commission suggested that if two services are performed for the same client and one service significantly reduces the usefulness of the other, then those services are incompatible. For example, if a public accountant provides such extensive management services that the distinction, consciously or unconsciously, becomes blurred between the auditors' viewpoint and that of management, the effectiveness of an independent audit will be lost. If users of the auditors' work <u>believe</u> that there has been a loss of objectivity, there may be an unwillingness to rely on the their work and again, the effectiveness of the independent audit will be lost.

It would be illogical to say that auditors should be prohibited from providing any service other than auditing. The auditor has gained specialized knowledge of the client's operations over a number of years. A new consultant would have to document the system and become familiar with the problem areas. Thus, the cost to the client would be greatly increased by the duplication of efforts. It is far more practical for each municipality to examine its own unique situation. If they are at least aware that there might be a problem, they can make a decision at that point. The role and responsibilities of the auditor should be reviewed regularly in any case, to ensure that the auditor does have an independent environment and is also free from management influences and unrealistic deadlines.

Following is a summary of additional services provided by auditors with a brief discussion of the service and its implications for the independence of the auditor.

1. Design and Installation of Bookkeeping Systems

The municipal auditor is in an ideal position to provide advice and assistance in the design and installation of bookkeeping systems through knowledge gained by working with a diverse client base. The auditor would also have indepth knowledge of the accounting records of an individual client.

Implication:
Changes to any system are expected to occur over a period of time. It is highly unlikely that the auditor would hesitate to suggest subsequent changes during the audit simply because of any involvement in the design and implementation of the original systems.

2. Bookkeeping Services

There are several different types of bookkeeping services which may be provided:

- bookkeeping services as record-keeping after the transaction has taken place;
- bookkeeping services before the transaction has taken place, which form part of the internal control procedures;
- bank reconciliations and other analyses or trial balances;
- preparation and posting of journal entries, and posting to the ledgers.

A number of auditing firms attempt to resolve any perceived conflict of interest by providing the bookkeeping services from a staff different from the auditing staff, or from a separate corporate entity. While this may work, the use of this kind of organizational structure would unfairly tend to favour the large

firm over the small firm or sole practitioner, which would not necessarily relate to the actual maintenance of independence.

Implication:
It is unlikely that the auditor's professionalism would result in an error not being corrected if it had been subsequently found as part of the audit, particularly when the auditor actually prepares the financial statements.

A recent survey of municipalities combined with direct interviews, did not identify the provision of bookkeeping services as creating any conflict of interest unless the auditor was part of the initiation or approval phases of the transaction.

3. Design and Installation of Internal Control Systems

The auditor is obligated to comment on weaknesses in the internal control systems observed during the course of the normal audit. The provision of a management letter which deals with internal control weaknesses has become a standard service provided by an auditor to all audit clients.

Implication:
One could see some risk to independence where the auditor recommended, or designed and installed changes in the internal control systems, and subsequently these changes prove to be ineffective or actually create a problem or financial loss to the municipality.

4. Interviewing for Professional Accounting and Financial Staff

Since the auditor has considerable expertise in bookkeeping and accounting, it is not unusual for the municipal client, or any other client, to request the auditor's assistance in the search

for, interviewing of, and training of bookkeeping and accounting staff.

Implication:
This might be where some conflict of interest may arise. Even though it is the municipality that actually makes the final decision, the auditor may have some reluctance in reporting to the client, when in the course of a subsequent audit, the person he recommended be hired has been identified as being incompetent or worse.

Whether the interviewing process is carried on by a separate corporate management consulting arm of the auditing firm would not be relevant, particularly if the auditor actually does the interviewing. This would probably be the case since the client would want the interviewer to be very familiar with the operations of the municipality.

5. Evaluating and Installing Computer Systems

The auditor has considerable experience with the evaluation and installation of computer systems. Therefore it is not unusual for the municipality to request the auditor's assistance for this purpose. Apart from computer systems in themselves, the auditor has considerable expertise with the design of the various reports which the computer systems would produce, and the appropriate internal controls to be considered.

Implication:
A conflict of interest may arise, and in all probability a perceived conflict will arise, where the auditor's own firm or its related management consulting wing or separate firm is competing in the municipality with other management consulting firms or computer systems organizations.

6. General Consulting Services

Because of the auditor's breadth of experience in many business areas, and association with the management consulting wing of the auditor's firm, general management consulting services are often provided. These services may extend beyond accounting or auditing matters and may involve other disciplines such as engineering. Included here would also be those services currently described as comprehensive auditing or value-for-money auditing.

Implication:
A conflict of interest may arise when subsequent audit findings bring the results of the consulting services into question. In addition, and as described above, there will probably be a conflict of interest where the municipality requests the auditor to review consultants' proposals and the consulting wing of the auditor's own firm is competing with other firms.

7. Preparation of Annual Financial Statements

The preparation by the auditor of the financial statements on which the auditor provides an opinion is the most widely raised issue when conflict of interest or loss of independence is discussed.

The question is whether the municipal auditor can remain objective about these financial statements and whether the opinion in the auditor's report is valid. Presumably the thinking is that, having prepared the financial statements, the auditor would overlook a misrepresentation or error in the financial statements which has been identified in the course of doing the audit.

Implication:
Where the auditor prepares the financial statements, and in the course of the audit finds an error in the financial statements, there can be no motive or benefit in not making the correction. Even where the client had perhaps seen a copy of the statement in draft form, the auditor would still make the changes. The financial statements are prepared near the end of the audit process. The double (or more) checking and review of the statements and working papers within firms also provides an element of independence.

Although it is the municipal treasurer's responsibility to prepare the financial statements, usually the majority of municipalities do have their financial statements prepared by their auditors. In many municipalities the treasurer has a dual role - as clerk and treasurer and in many instances - the major part of his or her training is in the clerk's function. Municipal auditors by virtue of training and experience are experts at preparing financial statements. They are also extremely knowledgeable about the reporting requirements for Ontario municipalities. Therefore it is both logical and economical to hire the auditor to actually prepare the financial statements. The same scenario occurs in the private sector. The vast majority of audit assignments include the preparation of financial statements. (This is not the case for the relatively few large audits for publicly traded corporations.)

One argument is that if the municipal treasurer cannot prepare the financial statements, the municipality should hire a treasurer who can. Alternately the municipality should hire a second public accounting firm to prepare the statements on which the first firm will express an opinion. The obvious duplication of effort and fees should cause this argument to be dismissed very quickly. Also, the two-firm approach in the northern parts of the province is unworkable because of the distances between

municipalities and the firms auditing them, and the resulting travelling costs.

CHAPTER 4 AUDIT FEES

This chapter identifies some of the factors that determine the level of audit fees and some of the criteria that can be used to evaluate the reasonableness of audit fees. These guidelines should however be applied carefully, since the quality of an audit is subjective and difficult to evaluate. A municipality should not try to emphasize low fees at the expense of quality. Another important aspect to any such ongoing service is the relationship between the auditor and the municipality. (See volume 1, of The Municipal Audit - Responsibility/Communication, chapter 5)

Components of Audit Fees

The audit process has many components. Audit firms charge fees according to a formula based on number of hours multiplied by staff charge-out rates, generally called per diem rates. Simplistically, they are selling their time based upon rates which reflect a certain level of expertise. The audit fee should not be the major criterion of an audit; however, many municipalities have been asking for proposals which may give average hourly rates, staff mix, estimated time, and out-of-pocket expenses.

On the next page is a chart showing the various components of the audit and where municipal assistance could be used to save the auditor time and the municipality money.

Auditor Responsibility	Municipal Action Required
INTERIM AUDIT auditor objective: . to examine, evaluate and test the system of internal control	. implementation of auditor recommendations for improvements in internal control
INTERIM AND YEAR-END AUDIT auditor requirements: planning to ensure: . early liaison with client to map out audit strategy . appropriate level and number of staff available . suitable timing of audit	. staff availability to assist audit staff in pulling and refiling documents . have narrative and flow-chart descriptions of accounting systems available . any internal audit staff work should be coordinated with external audit staff to avoid duplication of efforts
extent of testing: . emphasis on adequacy of internal control systems	. the poorer the internal control systems, the more testing required by the auditor, therefore the more time, therefore the more money
out-of-pocket expenses: . use of client's facilities	. make facilities available and ensure working conditions are adequate

Infrequent or Non-recurring Factors Affecting Audit Time

Provision Of Ancillary Services

Auditors are often requested to provide additional services which should be accounted for separately. The municipality should also be aware that the tendency to ask the auditor for advice on financial matters while he is on the premises for the year-end audit can be time-consuming enough to constitute an additional service. Time is money. Auditors also frequently provide extensive on-the-spot accounting training for municipal staff, which often goes unnoticed and is not easily separable.

Audit Of New Computerized Accounting Systems

In the first year of a new computerized (or manual) system, the auditor will have to:

(a) test the old system in place for part of the year;

(b) test the conversion to the new system; and

(c) test the new system.

This will take more time, and if the conversion did not go smoothly, the auditor may need to test an extremely large block of transactions.

Changes In Reporting Requirements By The Ministry Of Municipal Affairs

Occasionally there are major changes in reporting requirements requiring additional work on the part of the auditor.

Special Purpose Audits

Special purpose audits, including investigatory audits relating to irregularities, are usually subject to more intensive examination. This can often cost more than the audit of the entire municipality which is subject to testing transactions.

Assessing Audit Value

In order to determine the audit cost to the municipality, it is necessary to have the fee segregated into the various components. It should be noted, however, that where an auditor both prepares and audits the financial statement, a clean split is difficult. For example, while the auditor is reconciling an account and preparing journal entries, he is also examining documents and following any other auditing steps appropriate to that account. Most other services, however, can be listed separately.

When assessing the audit fee, the treasurer of the municipality can compare the fee with previous years and the estimates provided in the engagement letter, and analyse factors for significant changes. This should be done in consultation with the auditors so that explanations can be given. Audit fees should not be compared with other municipalities without taking numerous other factors into consideration. The size of the municipality is only one factor. Others are the sophistication of the accounting records available, the state of the municipality's records, the size and number of local and joint boards and the state of the boards' records, and the degree of assistance provided by municipal employees.

Audit Fee Disputes

Where the audit fee is in dispute, the treasurer should:

(i) request a meeting with the auditor to discuss the dispute;

(ii) analyse in detail the factors related to the audit fee submitted;

(iii) request the auditor to provide a detailed time analysis report and discuss the reasonableness of the fee in the context of the time analysis data;

(iv) negotiate with the auditor a satisfactory settlement of the fee dispute if possible; and

(v) if a satisfactory agreement cannot be reached, consider contacting the Institute of Chartered Accountants of Ontario regarding the fees mediation service provided to auditors and their clients free of charge.

Fees Mediation Services

Before submitting a fees mediation request, both parties should be in agreement on the use of the service and their written submissions should be sent to the Institute after such agreement has been reached.

The fees mediation service is only used in those circumstances where the auditor and the client cannot negotiate their own settlement.

When disputes are brought to the attention of the Institute and when both parties agree in writing to be bound by the decision of the mediation panel:

- the Institute obtains as much information as it deems necessary from both parties;
- mediator meets with each party or with a representative authorized by either party, provided such representative shall not be legal counsel;
- the mediation panel reviews both the material submitted directly to the Institute and the facts gathered by the mediator; and
- the mediation panel's decision as to an appropriate fee level is eventually confirmed to each party, in writing, with no reasons being given.

The submissions should contain the following:

The Client

- a request that the Institute appoint a mediator or mediators to mediate the fee dispute, naming the member concerned;
- an outline of the problem, stating the services rendered and the amount of fee in dispute and the reasons for the objection;
- an undertaking to attend meetings with the mediator(s) when requested and that it is understood that neither party will be represented or accompanied by legal counsel at such meetings; and
- an undertaking to be bound by the decision of the fees mediation panel.

The Member

- a request that the Institute appoint a mediator or mediators to mediate the fee dispute, naming the client concerned;
- an outline of the problem, stating services rendered, the amount of fee in dispute and the member's representation in support of the fee;
- an undertaking to make related working papers available to the mediator(s) and to disclose to the mediator(s) full particulars in support of the fee;
- an undertaking to attend meetings with the mediator(s) when requested and that it is understood that neither party will be represented nor accompanied by legal counsel at such meetings; and
- an undertaking to be bound by the decision of the fees mediation panel.

CHAPTER 5 THIRD PARTY LIABILITY

Third party liability of an auditor relates to the legal liability of the auditor for a loss suffered by a person other than his own client due to negligent performance of his work. In a municipal context, a third party might include lenders, bondholders, general creditors, ratepayers, other municipalities and local boards outside the control of the particular municipality as well as employees and unions. It must be emphasized that the list is tentative, since the law as it applies to municipalities may be subject to wide interpretations.

It is difficult to list the specific circumstances that could give rise to a third party action in the municipal sector, and whether the auditor or the municipality would be liable. Generally, they would be the same as in the private sector and involve misleading or misstated items in the audited financial statements.

Needless to say, a municipality should provide for an adequate errors and omission liability insurance coverage. Below is an extract from Bulletin No.18 on Liability Protection published by this Ministry.

> AVAILABILITY OF ERRORS AND OMISSIONS LIABILITY INSURANCE
>
> Errors and omissions liability insurance used to be available only to members of a recognized professional association, such as those for engineers, lawyers and physicians. Recently, with the increasing actions or threatened actions against employees and members personally, as well as the municipality or local board, the need for this

coverage became apparent. The misinterpretation of zoning by-laws, inadequate instructions to developers, or improper building inspections are some of the portential causes of action against the employee or the member.

Third party liability presumably would fall under this coverage.

A more indepth discussion has been provided in Appendix B.

FEATURES FOR A GOOD INTERNAL CONTROL SYSTEM

A. ORGANIZATION OF MUNICIPAL PERSONNEL

1. **A plan of organization.** A written formal plan of organization should include a description of areas of responsibility and job functions.

2. **Competence and training of employees.** Employment policies should reflect an emphasis upon employee competence and duties assigned should be commensurate with the capabilities of the personnel. Continued training should be a part of the program.

3. **Honesty.** The background of prospective employees should be investigated to determine honesty and integrity.

4. **Bonding.** Employees should be bonded to insure against embezzlement losses.

5. **Supervision.** Employees should be properly supervised to ensure that duties are being carried out as assigned.

6. **Fixing responsibility.** If responsibility is fixed, the failure to discharge duties adequately can be easily traced. The control factors also establish an accountability for losses due to inefficiency or fraud.

7. **Division of duties.**

a) No one in complete control. No one person should be in control of an entire transaction. Such complete control would permit the employee to operate inefficiently, or fraudulently without detection.

b) Separate custodianship. The individual in charge of recording or maintaining accounting control over assets should not have physical access to or custody of those assets.

c) A system of double check. Duties should be so divided that one person checks on the accuracy of the work of another person such as the reconciling of the taxes receivable subledger with the general ledger.

8. **Performance standards.** Establishment of performance standards and periodic comparison and monitoring of actual performance against those standards should be developed.

9. **Authorizations.** The procedures should provide for a system of authorization at various levels to prevent unauthorized actions. The fact that the authorization may be lacking in a given circumstance would call for immediate investigation.

10. **Internal auditing.** Many large municipalities employ internal auditors whose function is to audit detailed transactions, review the accounting and operational procedures and determine the adequacy of the internal control system and the extent of compliance with municipal policies.

11. **Independent examination.** The possibility of examination by the independent public accountant is, in itself, an important control feature.

B. SYSTEM OF PROCEDURES, RECORDS AND RECORDKEEPING

12. **Written manuals.** The accounting and operational procedures should be set forth in accounting and procedures manuals so that the policies and instructions may be explicitly known and uniformly applied. The existence of a chart of accounts, for example, will aid in the application of accounting policies, in the proper recording of transactions and facilitate the preparation of financial statements.

13. **Budget to actual comparison.** Operating and capital budgets should be maintained and a periodic review of actual results compared to budgeted projections and follow-up investigation of significant variances should be undertaken.

14. **Internal reporting.** Formalized internal reporting system should be set up requiring the preparation of financial reports and statements on a daily, weekly, monthly, quarterly and annual basis.

15. **Accounting controls.**

a) Maintaining a general ledger, chart of accounts and taking of trial balances on a regular basis are internal control features that:

i) assist in ensuring transactions are recorded in a timely and orderly manner in one central document;

ii) aid in detecting errors or discrepancies if the trial balance does not balance (i.e. credits do not equal debits);

iii) serve as a primary documentary reference source for investigating problems or errors in that all postings to the general ledger have been obtained from books of original entry; and

iv) aid in maintaining the integrity of the management information system.

b) Maintaining journals, subledgers and other posting documents provides support for the postings by detailing the underlying documentation and transactions involved. In addition, these related books-of-account ensure the division of duties amongst staff in that, if at all possible, the custodian of the general ledger should not be responsible for, or be involved in maintaining these other accounting records.

c) Balancing and reconciliation procedures are internal control elements in that they detect errors or discrepancies that require investigation and solution.

d) Cut-off routines are those which relate to ensuring transactions are recorded in the accounting records in the appropriate time or reporting period. This is extremely important at year-end when a precise determination has to be made as to what transactions should be included in the year's financial statements. A misallocation of amounts could result

in a significant over-/ or under-statement which could impair year-to-year comparisons.

e) Validation stamps should be used to ensure all the necessary procedures and authorizations have been performed and duly noted, if later on an investigation has to be conducted into an error or irregularity.

16. **Forms and documentation.**

a) Use standardized forms and documents to promote uniformity of accounting records.

b) Use pre-numbered documents to control the numerical continuity of documents and consequently be able to follow up missing forms where the numerical sequence is not maintained.

17. **Restricted access.** Restrict access to confidential and important records and unused document forms as well as to assets such as cash or other negotiable assets. Restricted access is important to make certain only authorized personnel have physical access to the accounting records or assets. In this way responsibility can be clearly assigned to an individual to ensure adherence to correct and proper procedures.

18. **Signing authority.** Signing authority procedures should be employed to serve as a record as to what was approved, reviewed or authorized by whom. For example, cheque-signing authorization is an important internal control over the issuance of cheques.

19. **Periodic counts.** Periodic counts should be conducted and results compared to the related accounting records; such as, for example, counting and comparing petty cash on hand to the petty cash balance recorded in the general ledger.

20. **Frequent reconciliations.** Make frequent reconciliation of subsidiary accounts to general ledger control accounts; for example, compare total of individual tax arrears amounts to the total in the general ledger account.

21. **Publicity.** If the internal control policies and procedures are publicized, deviation from approved practice may be discouraged or detected.

22. **Authorization.** Transactions should be properly authorized by appropriate personnel.

C. AUTOMATIC AND MECHANICAL SAFEGUARDS

23. **Adequate insurance.** The municipality should be adequately insured against fire and legal liabilities.

24. **Custody devices.**

a) Protection of records in locked filing cabinets and vaults serves as an internal control feature over fire, theft or unauthorized use.

b) Use of equipment such as cheque-signing protectograph machines, bookkeeping machines and cash registers also serve as internal control devices to prevent easy alteration or manipulation of amounts.

25. **Correspondence log.** Record all correspondence received in a log book on a daily basis.

APPENDIX B

CONTINUED DISCUSSION OF THIRD PARTY LIABILITY

The law in this respect has undergone a significant change. The old rule held that only a client could recover because the liability could arise only out of a breach of a contractual relationship between a defendant and client. Until recently, this "privity of contract" principle was absolute in barring a third party from recovery. The equity of completely disregarding third party rights had been questioned increasingly over the years and in 1963, a landmark court decision in the United Kingdom, the Hedley Byrne v Heller case seemed to launch a new day for a third party by extending the liability beyond the bounds of contractual relationships.

Common law

The law created by a decision of the judges rather than the statute or codified law established by legislative bodies is known as common or case law. A previous law as re-interpreted then sets a precedent in how the lower courts apply it in subsequent cases. The courts, in adapting the existing legal principles, are acknowledging the changes in customs and conventions that have taken place in society and reflecting them in law to suit new realities and circumstances.

Law of tort

The legal responsibilities of an auditor fall under the three categories of statute, contract and tort. If an auditor fails to meet any of these legal responsibilities he may become legally liable. Tort is a civil wrongdoing as opposed to a criminal wrongdoing and is independent of contract. The courts will

redress for the injury or harm caused as a consequence of anyone who, while doing anything at all, fails in his duty to do so with proper care.

Law of negligence

The law of negligence governs such tort suits. Most actions brought against an auditor by a third party fall under the law of negligence as a result of the auditor failing to perform a legal duty or failing to perform that duty with the requisite standard of care. In law there can be no negligence until there exists a legal duty to take care.

The law will impose a duty of care wherever the circumstances of one person's relationship to another are such that, first, the person's actions or omissions could reasonably be expected to cause injury to that other person or his property. The second element in an action of negligence is a failure to conform to the standard of care that the law requires. The third essential element of negligence is proof that the plaintiff has suffered damage. The fourth is a reasonable cause and effect connection between the breach of duty and the resulting damage.

The plaintiff must establish adequate proof of all four elements to succeed. For instance, if an investor suffered losses but never read the particular financial statements, nor placed any reliance on them, the litigation may fail.

The courts have developed the "foreseeability test" requiring a person to take due care to avoid acts or omissions which he can reasonably foresee and which would likely injure a neighbour. For an auditor this generally means that he is held liable for negligence to a limited class of third parties who, relying on his negligent report, undertakes a commitment and suffers a

financial loss. However, he is not responsible to "an indeterminate class" of third parties.

Legal duty of care

The legal duty of care is based on the principle that anyone holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment must perform his work with the standard of care and skill identified with the group. A public accountant must perform his work with the care and skill which a reasonably competent, careful and cautious auditor would use. The standard by which the auditor's work is judged is not the highest of the auditors, nor the lowest but that of "a reasonable man."

In determining the standard of legal duty of care of an auditor, the courts have generally referred to the profession's Rules of Conduct and the generally accepted auditing standards required of members in the provincial professional body of public accountants. The topic was discussed earlier in chapter 1 of "The Municipal Audit - Responsibility/Communication." Courts may apply a higher level of care since legal concept is influenced both by legislative provisions and by past decisions in the courts. Also, specific terms in a contractual agreement may call for a higher standard of care.

Turning points

The first important doubt cast on the equity of the privity of contract concept came in 1951 in an English case.[1] A defendant auditor was found innocent on the privity of contract rule but one of the judges observed that "the law would fail to serve the best interests of the community if it should hold that

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[1]Candler v Crane, Christmas & Co. (1951) 2 KB 164.

accountants and auditors owe a duty to no one but their client.... If such be the law, I think it is to be regretted, for it means that the accountant's certificate, which should be a safeguard, becomes a snare for those who rely on it."

In the historic 1963 case, the House of Lords enunciated doctrines which rejected the defence of absence of the privity of contract. It stated that persons should be held liable for negligent misrepresentations to third parties, even though unidentified at the time, whose reliance on their statements could be reasonably foreseen. The Law Lords qualified the last statement by recognizing that there must be some limits in extending liability to unknown third parties; otherwise, as earlier stated by a prominent U.S. judge, it would "... expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."

The Hedley Byrne case has had a profound effect on auditors throughout the countries of English common law roots with the decision in one country impacting on others. It has radically widened auditors' legal responsibilities and initiated a new base for actions against the auditors. In the past few years a sharp increase in general litigations and out-of-court settlements in the United States, Great Britain and Australia has been reported. No figures, official or otherwise, are available for Canada.

There is a popular perception that this recent surge is directly linked with the application of the Hedley Byrne principles. However, on analysis, it appears that a major portion is attributable to fraud actions (in contrast to third party actions), the propensity in the United States of the lawyers accepting these actions on a contingency fee basis and a delayed decision in a major fraud case involving a large U.S. auditing firm. The "deep pocket" syndrome, which is explained later, has been a significant contributor to the total. Certainly, it is

odd that this increase is taking place almost two decades after the historic decision.

Here in Canada, the doctrine has been applied against an auditor once by the Supreme Court in the Haig v Bamford case in 1976. Our highest court seems reluctant to widen the Hedley Byrne principles with respect to auditors. The lower courts, whose decisions are reported prominently in the journals, reflect the same approach.

The controversy over third party rights has been simmering for nearly a century, and it still continues despite the important precedent. One conclusion seems apparent; the courts throughout the common law countries have not set aside the privity rule in the way one might have thought after reading the legal accounts at the time. The strength of the privity rule has averted the kind of increased court awards the auditors feared.[2]

Also, it should be remembered that a court's decision may be determined on a legal point which overrides the suit. It is important to bear in mind that in a third party action - and, therefore, involving negligence - the litigant must prove successfully all of the four prerequisite elements referred to earlier. A number of cases have failed on this fundamental point.

Furthermore, the courts have had considerable difficulty with third party liability cases involving auditors since each must relate to the particular statutory and case law of their jurisdiction which can vary importantly from one country to

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[2]Students of law are directed to a Privy Council case which came after the Hedley Byrne case and specifically limited the scope of the doctrine outlined in Hedley Byrne, the Mutual Life Assurance v Evatt (1971) AC 793. As the case was decided by the Privy Council, it did not have binding authority but has managed to carry persuasive influence in mitigating the doctrine.

another, and on the surrounding circumstances of each case. The problem is complicated by such factors as: two different legal interpretations existing at one time; whether the statements are unaudited or audited; how quickly and responsibly the plaintiff acted to minimize the damage; whether a disclaimer of opinion has been issued; whether the judgment and the awards are consistent; and whether a decision has been upheld or overturned by a higher court. As a result it is often extremely difficult to state exactly what the law is on a particular issue.

Concerns of the auditor

The extension to third parties of the action for negligence has serious implications for the auditor. If an auditor is found guilty in a third party action for negligence and his resources and insurance are insufficient, he may be placed in grave financial difficulty, possibly losing all his personal assets.

The problem has been compounded by the reduced insurance coverage and the recent sharp rise in insurance premiums as a result of the increased legal damages awarded to third parties. As a result, most Canadian accounting firms, at least the small- and medium-sized ones, rely on the Canadian Institute of Chartered Accountants endorsed insurance program. It is estimated that a good number of them require a larger coverage than the maximum coverage of $2 million which was increased in 1987 from $1 million. This program basically covers negligent act, error or omission, and breach of contract or duty.

The large international firms have arranged their insurance through a broker who deals with them on an international basis. In the past few years, some firms with coverage as high as $250 million have had it reduced to $50 million for which the premium is four times as much. It is the insurance above the self-insured layer that poses the greatest problem. There simply is

no market prepared to write reinsurance for accountants at such catastrophic levels.

Thus, the reduced coverage is more of a problem than the increased cost, since the very livelihood of an accounting firm may be in danger should the damage claim exceed the insurance coverage. To overcome this problem, the profession is advancing a number of legal amendment proposals which would have the effect of limiting the amount of a claim. One proposal is to place a statutory cap on the losses arising from liability claims; another is to allow auditors to incorporate themselves or to allow a limited partnership.

The accountants, along with other professions, are lobbying to have The Negligence Act amended so that the joint and several liability aspect of the law is eliminated and replaced by joint liability. Joint and several liability is a legal term applied to an obligation that allows a creditor to collect from one liable party separately or from all liable parties together, whereas several liability is an obligation that is separate and distinct from the liability of another. The proposal would prevent a plaintiff collecting from one member, or from all of them together until the liability is satisfied, irrespective of the proportionate blame in the action. This is known as the "deep pocket" syndrome where a minor party such as an auditor may become liable for a major portion of an award.

Implications

The possibility of a third party action against the municipality's auditor should cause municipalities to look more carefully at the needs and rights of their own third parties.

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